

View point

Is Islamic Finance, Social Finance?

Saadiah Mohamad *

Arshad Ayub Graduate Business School, Universiti Teknologi MARA, Malaysia

1. Introduction

Developments in Islamic Finance and Social Finance illustrate an increasing interest globally to look at alternative ways of financing and creating value in the society. Islamic Finance and Social Finance are emerging disciplines that challenge and influence the global finance industry and both have similar mandates in terms of their emphasis in ethical business and investment. Islamic Finance is governed by the rules of the shariah that prohibits *riba* or interest and *gharar* (uncertainty), sinful business sectors such as pornography and alcohol and unethical practices such as excessive speculation and gambling. These forms of restrictions are similar to the negative screening methodology adopted by the socially responsible investment or SRI which is a rising component of Social Finance.

Ethical Investment Research Service (EIRIS, <http://www.eiris.org/>) defines a green or ethical SRI fund as a fund where the choice of investment is influenced by one or more social, environmental or other ethical criterion. Islamic investment is regarded as SRI since it applies an ethical screening process that excludes certain industries (Binmahfouz 2012). In the last decade SRI has seen rapid growth as investments that combine financial objectives with social, environmental, ethical and corporate governance issues have become important to an increasing number of investors globally.

The UN introduced in 2006 the Principles for Responsible Investment (PRI) to promote awareness of environmental, social and governance (ESG) issues. The SRI mandate provides the framework for global SRI practice principles used by over 800 leading global institutional investors with over US\$ 22 trillion in total asset under management or AUM (EUROSIF 2010). Historically the SRI started with religious groups hundreds of years ago when they tried to avoid investing in sin industries such as alcohol, tobacco, gambling and arms industry. Churches in the US and UK in 1900s played an important role in introducing the concept of SRI to the markets. Despite being historically rooted with religious groups, modern SRI activist came about in response to the political climate of the 1960s and 1970s as a result of the rise of human right awareness, anti war activism against Vietnam War and opposition against the apartheid. In the 1980s and the 1990s, the SRI evolved further to include the positive screening by giving support to (screening in) industries that promote alternative energy sources, equal employment opportunities, adopt corporate governance and etc. (Binmahfouz 2012). Thus the concept of SRI has been broadened to not only include the negative screening but also the positive screening in order to reduce the negative impacts and promote positive innovations and contributions to society.

Despite such developments, and attempts by global indices such as the Dow Jones Sustainability Index introduced in 1999 that defines SRI in terms of the so called sustainability measure using the “best

* Saadiah Mohamad. Tel.: +0-000-000-0000 ; fax: +0-000-000-0000 .
E-mail address: saadiah228@salam.uitm.edu.my.

in class” methodologies based on top performers in financial performance, environment and social and corporate governance, the definition for what is SRI is still far from being clear and a global consensus is difficult to reach. This is because in the issue of ethics, what is ethical can vary from one group to another and from one set of belief to another. In this sense, shariah compliant investment can be argued to have a more transparent and globally accepted set of methodology as evidenced in the meteoric rise of Islamic investment such as in the sukuk and Islamic funds market globally.

Despite the existence of various Islamic schools of thoughts that offer differing shariah interpretations across jurisdictions, global shariah standards setting bodies like the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) and the Islamic Financial Services Board (IFSB) as well as the rise of global shariah indices such as the Dow Jones Islamic Market World Index, S&P Global BMI Shariah Index, MSCI ACWI Islamic and FTSE Shariah All-World Index, point to the rapid developments towards globally harmonising the industry. Unlike the SRI or the ethical investment which focus on the environmental, social and governance issues or the ESG but lacks a clear standard framework, the point of reference for Islamic investment is the shariah held in common by all the relevant jurisdictions, hence this provides the framework to develop the shariah compliant screening processes. In addition, differences in shariah interpretations are not fundamental issues and market players have the incentive to reduce major differences as risks emanating from this known as “shariah risks” can be costly to both issuers and investors and can harm the reputation of not only the companies involved but markets and regional hubs as well as sovereigns interested to push the industry as alternatives to conventional finance.

2. Screening Methodologies

So while not all SRI is Islamic Finance because of the requirements of the shariah screening criteria, could Islamic Finance be regarded as part of Social Finance or be linked to it in some ways? Is there a need for Islamic Finance to be recognised as being possibly part of Social Finance?

Social Finance can be defined as an approach to mobilizing private capital that delivers a social dividend and an economic return to achieve social and environmental goals (Government of Canada 2014). An examination on the underlying principles and objectives of both Islamic Finance and Social Finance uncover a great deal of similarities between them. Both have similar mandates in terms of being ethical and having a wider set of social objectives. Both exclude companies which are considered unethical: alcohol, tobacco, arms defence and pornography. On top of this, Islamic finance excludes conventional financial sectors involved in interest and impose financial screening ratios for levels of debt and interest – based income. In contrast, SRI emphasise the importance of environmental risk, social and corporate governance or the ESG issues.

The Islamic screening methodology focus on the shariah permissability of the business output and the level of interest based activities while the non income generating aspects on social, environmental concerns are not incorporated. Should Islamic Finance be greener? Should it too consider like Social Finance, the ESG issues which now become global concerns in view of problems related to climate change, acute income and wealth inequality across the globe and a culture of unhealthy and unethical

business practices based on greed that give rise to many of the problems in the world including company collapses and financial crises and meltdowns.

3. Should Islamic Finance be Greener?

And yet the scholars and practitioners of both disciplines seldom engage with one another. We witness today the lack of concern among Islamic financial institutions in the field of social innovations in Islamic Finance (ISRA 2009, 2012) and likewise the social innovations in Social Finance do not tap from the innovative financial engineering that drives Islamic Finance to command a position of continued strength in the global financial landscape. There is no doubt that the Islamic Finance industry has grown in size over the past three decades. Its magnanimity lies not only in its claims and hope to contribute to some of the world's most pressing issues, but the industry as a whole has by now shown some impressive track records. Its shariah compliant investment schemes not only can be at par but they even outperformed some of the best performing industry benchmarks (Kamso 2013).

Discourses on Islamic Finance particularly in relation to the issue of “form” and “substance” and the discourse on *maqasid al shariah* (objectives of shariah) points to an important aspect of value proposition of Islamic financial products. The shariah compliance by itself satisfies the “legalistic form” and should embed some minimum standard of the “substance”. It is also in the spirit of the *maqasid* that the industry should be inclusive, and that it considers justice and the well being of the society at large as sacred. The *maqasidic* approach also has the objective of preserving the *maslahah* or public interest of reducing or avoiding harm and maximising social benefits and thus the ESG issues are in fact Islamic issues. Thus, it can be argued that shariah compliant products, unlike the conventional instruments, by virtue of it being shariah compliant in its form must have embedded in it the “substance” where social and ethical values are incorporated in the structuring and distribution of the products. But is this true of the existing shariah products in the market, both in terms of the quality and the range of products to serve the higher objectives of the shariah?

There is an absence of meaningful equity based financing instruments in Islamic Finance, and yet equity instruments such as the *mudarabah* and *musharakah* instruments should be, as argued by Islamic scholars to be the primary substitute for interest bearing financial instruments (Iqbal and Mirakhor 2007).

According to Dr Abbas Mirakhor “We need to extrapolate from the present stage of evolution of Islamic finance to see what it will look in future. Alternatively, we can ask what is the vision for Islamic finance all about, and then try to work our way back to see if there is convergence with what is presently available” (ISRA 2010).

The vision I believe is that Islamic Finance should make a difference not just to the HNI (High Networth Individuals) or the sovereigns and the big corporate players, but that it should be diffused in the social fabric of the society, much like the *waqf* based social and economic activities of the Ottoman and the Andalusian civilisations, the model of which inspire many endowment based institutions and great universities in the world such as the University of Oxford. For this, innovations in Social Finance (Lehner 2011, 2012, 2013) and social entrepreneurship (Nicholls 2008, Lehner et al 2011) can instigate the development of more shariah compliant financial instruments which can help expand the universe for Islamic products. Product proliferation being much needed by the Islamic Finance industry, attracts new

Islamic investors and increases the investor base which promotes income redistribution, financial inclusion and stability.

Islamic Finance is often criticised for its lack of commitment to making a real difference for the welfare of the bottom billion in the world or the bottom 40 percent of any economy's population. Many Muslim countries are either poor or are emerging economies. For the past 30 years, apart from some countries like Malaysia which has its early years of development in retail banking and the growth of collective investments like the unit trusts which has seen some retail distribution, much development in the global finance industry tend to benefit the high networth individuals (HNI) and the corporate players, with limited participation from public or giving benefits to the marginalised sector. What has developed apart from initiatives on waqaf and zakat indicate a clear lack of innovations for social objectives. Indeed the Islamic capital market with its impressive development in sukuk issuance does contribute to the economic and infrastructure development of many countries, but developments in socially ethical or responsible investing and other social innovations are clearly lacking. Even for the sadaqah or endowment sector where HNIs are also generous philanthropists, what could be better will be the mobilisation of these endowment funds to create financing for sustainable social projects. This rather than a one off hand outs empower the people and build capacity for a community or an economy.

4. Research Agenda

The discussion we have here has important research implications. Firstly, there is a need to link Islamic Finance with Social Finance and to compare and contrast the growth and developments of the two disciplines, and secondly, to develop new models to expand the universe of shariah compliant financial instruments which can provide financing for projects with social returns. These are either business projects with social impacts similar to ethical investing in the conventional space or social innovations that look for price discovery by transforming social capital which are publicly funded or yet to be funded into securitised community instruments which then act as low risk investment tools for the community. These new products will add to the existing lack of social tools and expand the universe of shariah compliant products.

This inquiry serves to broaden the perspectives of each discipline. In particular, Islamic Finance both as an academic discipline and as an industry can expand its frontiers of knowledge and the universe of shariah compliant products by developing more innovative instruments with social returns, inspired by emerging innovations in Social Finance. Likewise, Social Finance should incorporate under it, Islamic Finance since it has embedded in it notions of social objectives as embodied in the *maqasid shariah*. Proponents and activists of Social Finance not only gain from the knowledge in creative financial engineering but also potentially access a highly lucrative source of funding that remains untapped by social entrepreneurs. Linking the two, Islamic Finance and Social Finance will bring both disciplines outside their habitual circle of influence and in doing so brings people of similar noble intentions in a market where greed and profit maximisation pale in comparison with a higher objective of providing financial solutions to support sustainable social changes that benefit the community and society at large.

5. References

- Binmahfouz, S. 2012. *Investment Characteristics of Islamic Investment Portfolios: Evidence from Saudi Mutual Funds and Global Indices*. Durham theses, Durham University. Available at Durham E-Theses Online: <http://etheses.dur.ac.uk/4440/>
- Iqbal, Z. and Mirakhor, A. 2007. *An Introduction to Islamic Finance – Theory and Practice*. Wiley Finance.
- ISRA Bulletin. 2012. *Rethinking the Direction of Islamic Finance*. An Interview with Sheikh Dr Mudassir Siddiqui. Vol. 12, August 2012.
- ISRA. *The Frontiers of Innovation in Islamic Finance*. Proceedings of the Second Oxford Islamic Finance Roundtable. Kuala Lumpur. 15 April 2009.
- Lehner, O.M. and Kansikas J., 2013, *Pre-Paradigmatic Stage of Social Entrepreneurship: A systematic Literature Review*, Journal of Social Entrepreneurship, 4(1), (ISSN: 1942-0676)
- Lehner, O.M., 2013, *Crowdfunding Social Ventures: A Model and Research Agenda*, Journal of Venture Capital, 15 (3), 1-21 (ISSN: 1369-1066)
- Lehner, O.M., 2011. *The Phenomenon of Social Enterprise in Austria: A Triangulated Descriptive Study*. Journal of Social Entrepreneurship, 2 (1), 53-78. (ISSN: 1942-0676)
- Lehner, O.M., 2012. *Sociavl Entrepreneurship Perspectives: Triangulated Approaches to Hybridity*. JSBE: Helsinki, Finland, 177 p., (ISBN 978-951-39-4661-6)
- Lehner, O.M., 2013. *Debt and Equity based Crowdfunding of Social Ventures*, forthcoming in the Oxford Handbook of Social Finance, A. Nicholls et al. (Eds.), Oxford University Press, UK.
- Lehner, O.M. and Kansikas J., 2011. *Social Entrepreneurship Research across Disciplines*, J.L. Laville (Ed.), paper presented at the 3rd EMES research conference, Roskilde, DK.
- Noripah Kamso. 2013. *Investing in Islamic Funds: A Practitioner's Perspective*. Wiley: Singapore.